

**Letter of Findings Number: 06-0064  
Adjusted Gross Income Tax  
For the Tax Period 1998-2001**

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**ISSUES**

**I. Adjusted Gross Income Tax – 2000 Increase in Federal Taxable Income**

**Authority:** IC § 6-8.1-5-1(b); IC § 6-3-2-1; IC § 6-3-1-3.5(b).

The Taxpayer protests the adjustment increasing the 2000 federal taxable income.

**II. Adjusted Gross Income Tax-2001 Increase in Sales**

**Authority:** IC § 6-3-1-3.5(b).

The Taxpayer protests the adjustment increasing the 2001 sales.

**III. Gross Income Tax-Destination Sales**

**Authority:** IC § 6-2.1-1-1(a)(2); IC § 6-2.1-3-3; [45 IAC 1.1-3-3\(d\)](#); [45 IAC 1.1-1-3](#).

The Taxpayer protests the assessment of gross income tax on destination sales.

**IV. Adjusted Gross Income Tax-Net Operating Loss Carry Back**

**Authority:** IC § 6-8.1-5-1(c).

The Taxpayer requests instruction on the utilization of net operating loss carry backs.

**V. Tax Administration- Ten Percent Negligence Penalty**

**Authority:** IC § 6-8.1-10-2.1; [45 IAC 15-11-2\(b\)\(c\)](#).

The Taxpayer protests the imposition of the ten percent negligence penalty.

**STATEMENT OF FACTS**

The Taxpayer is in the telecommunication business. Pursuant to an audit, the Indiana Department of Revenue (Department) assessed additional gross income tax, interest, and penalty for the years 1998-2001. The Taxpayer protested and a hearing was held. This Letter of Findings results.

**I. Adjusted Gross Income Tax- 2000 Increase in Federal Taxable Income**

**DISCUSSION**

The Department added back a \$51,133,330 deduction taken on the Indiana return to the Taxpayer's 2000 federal taxable income as reported on Schedule B of the Indiana Corporation Income Tax return. The Taxpayer protested this disallowance of its deduction. The Taxpayer and its subsidiaries filed as a federal consolidated group. To prepare the federal return, the Taxpayer first prepared pro forma federal returns for itself and each of its subsidiaries. The Taxpayer reported the entire M-1 adjustment relating to "cross-border corrections." The adjustments were made to several entities in the federal consolidated group on the Taxpayer's pro forma federal return. The Taxpayer contended – that for ease of preparation – it took the M-1 adjustments on the Taxpayer's return when they actually should have been allocated among the related corporations. Therefore, the Department should not have added the M-1 adjustments back to the Taxpayer's Indiana taxable income in determining its Indiana tax liability.

All tax assessments are presumed to be accurate. IC § 6-8.1-5-1(b). The Taxpayer bears the burden of proving that any assessment is incorrect. *Id.*

Indiana imposes a corporate adjusted gross income tax "on that part of the adjusted gross income derived from sources within Indiana of every corporation." IC § 6-3-2-1. A corporation's adjusted gross income is determined by starting with the corporation's federal taxable income with certain modifications as set out in Indiana law. IC § 6-3-1-3.5(b). There is no statutory deduction for M-1 adjustments reconciling "cross-border corrections."

The Taxpayer provided a computerized spread sheet showing that all of the adjustments actually related to the other corporations and Massachusetts State income tax returns to substantiate its argument that the Department should not have added back the M-1 adjustment to the Taxpayer's income. This documentation was inadequate to sustain the Taxpayer's burden of proving that its original pro forma federal tax return was inaccurate and the M-1 adjustments only related to the Taxpayer's related corporations.

**FINDING**

The Taxpayer's protest is respectfully denied.

**II. Adjusted Gross Income Tax-2001 Increase in Sales**

**DISCUSSION**

The Department increased the Taxpayer's 2001 gross receipts before apportionment by disallowing a deduction for an "unaccountable difference" between the sales reported on the sales reporting system for sales and use tax purposes and the sales reported per the general ledger. The Taxpayer protested this adjustment

contending that there were a variety of reasons that the differences would exist. These included the difference in revenue recognition rules for sales taxes versus book accounting; customer refunds and credits processed outside the sales tax system but recorded on the general ledger; and reissued customer invoices for purposes of correcting tax amounts, but without adjusting gross sales in the accounting system thus creating duplicate sales amounts.

A corporation's adjusted gross income is determined by starting with the corporation's federal taxable income with certain modifications as set out in the Indiana law. IC § 6-3-1-3.5(b). The Department applied this statutory mandate to the Taxpayer's federal workpapers for 2001. Later the Taxpayer amended its federal returns to reflect information not available at the time of the audit. These circumstances are adequate to warrant further audit review of the assessment.

#### **FINDING**

The Taxpayer's protest is sustained subject to audit verification.

### **III. Gross Income Tax-Destination Sales**

#### **DISCUSSION**

The Department assessed additional gross income tax on the Taxpayer's sales to Indiana destinations that were invoiced to out-of-state customers. The Taxpayer protested the assessment contending that the sales were destination sales insufficiently connected to the Taxpayer's Indiana office to be subject to gross income tax. Therefore, the sales were exempt as sales in interstate commerce.

During the tax period, Indiana imposed a gross income tax on that portion of a non-resident's income that was "derived from activities or businesses or any other sources within Indiana." IC § 6-2.1-1-1(a)(2). There is an exemption from the gross income tax at IC § 6-2.1-3-3 as follows:

Gross income derived from business conducted in commerce between the state of Indiana and either another state or a foreign country is exempt from gross income tax to the extent the state of Indiana is prohibited from taxing that gross income by the United States Constitution.

The Taxpayer argued that its income was derived from interstate commerce and therefore qualified for the interstate commerce exemption.

In order to avoid offending the Interstate Commerce Clause, gross income tax assessments must meet the requirements found at [45 IAC 1.1-3-3](#)(d) as follows in relevant part:

Gross income derived from the sale of tangible personal property in interstate commerce is subject to the gross income tax if the sale is completed in Indiana. The following examples are situations where a sale is completed in Indiana prior to or after shipment in interstate commerce:

...

(7) A sale to an Indiana buyer by a nonresident seller if the sale:

- (A) originated from;
- (B) was channeled through; or
- (C) was otherwise connected with;

an Indiana business situs established by the seller.

The definition of "a business situs" is clarified at [45 IAC 1.1-1-3](#) as follows:

(a) A "business situs" arises where possession and control of a property right have been localized in some business or investment activity away from the owner's domicile.

(b) A taxpayer may establish a business situs in ways, including, but not limited to, the following: agency route, or other place where the taxpayer's affairs are conducted.

(1) Use, occupancy, or operation of an office, shop, construction site, store, warehouse, factory, agency route, or other place where the taxpayer's affairs are conducted.

(2) Performance of services.

(3) Maintenance of an inventory or stocks of goods for sale, distribution or manufacture.

(4) Sale or distribution of merchandise from company-owned vehicles where title to the goods passes at the time of sale or distribution.

(5) Acceptance of orders without the right of approval or rejection in another state.

(6) Ownership, leasing, rental, or other business activities connected with income-producing property (real or personal).

(7) Ownership (in whole or in part) of a partnership doing business in Indiana unless the ownership is that of a limited partner who does not participate in the control of the business.

(8) Other business or investment activities, other than de minimis, performed on behalf of the taxpayer by an employee of the taxpayer. These activities shall be considered together, not in isolation, in deciding if they are de minimis.

The Taxpayer leased an office in Indiana with several Indiana employees. This decision established an Indiana situs for the Taxpayer. The issue is whether or not the sales on which gross income taxes were assessed were channeled or funneled through the Taxpayer's Indiana situs.

The Taxpayer produced significant documentation that the sales to a national communications corporation were negotiated outside of Indiana. The contract for the sale was signed outside of Indiana. The sale was

facilitated by sales personnel from offices in other states. The invoices were sent to corporations outside of Indiana. The property was delivered from an out-of-state location directly to the Indiana customer. This sale was made in interstate commerce and not was subject to the Indiana gross income tax.

Although the Taxpayer claimed that it could provide similar documentation for each of the other sales, it failed to do so. The Taxpayer contended that it was impractical to do so because of the large number of destination sales upon which gross income tax was assessed. The Taxpayer requested that the Department develop a representative sample to examine for determination of the taxability of the entire group.

#### **FINDING**

The taxability of the Taxpayer's remaining sales is to be determined by the Audit Division which will, through the use of a statistical sample, determine if additional sales are exempt from Indiana Gross Income Tax.

#### **IV. Adjusted Gross Income Tax-Net Operating Loss Carry Back**

##### **DISCUSSION**

The Taxpayer requested information from the Department on how to utilize their net operating losses.

Administrative hearings are held to determine whether or not a proposed assessment was correct and to discuss the reasons for the Taxpayer's protest of a proposed assessment. IC § 6-8.1-5-1(c). An administrative hearing is not the proper venue to seek advice on how to handle specific tax issues such as the utilization of net operating losses.

#### **FINDING**

There is no determination to be made for this issue.

#### **V. Tax Administration- Ten Percent Negligence Penalty**

##### **DISCUSSION**

The Taxpayer protests the imposition of the ten percent negligence penalty pursuant to IC § 6-8.1-10-2.1. Indiana Regulation [45 IAC 15-11-2](#)(b) clarifies the standard for the imposition of the negligence penalty as follows:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The standard for waiving the negligence penalty is given at [45 IAC 15-11-2](#)(c) as follows:

The department shall waive the negligence penalty imposed under [IC 6-8.1-10-1](#) if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

- (1) the nature of the tax involved;
- (2) judicial precedents set by Indiana courts;
- (3) judicial precedents established in jurisdictions outside Indiana;
- (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc;
- (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

The Taxpayer provided sufficient documentation to indicate that its failure to pay the assessed income tax was due to reasonable cause rather than negligence.

#### **FINDING**

The Taxpayer's protest is sustained.

*Posted: 04/18/2007 by Legislative Services Agency*

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